Rakyat Berjaya Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri

HIGH COURT (KOTA KINABALU) — MISC APPEAL NO K 03 OF 1995
CHARLES HO J
10 OCTOBER 1997

Revenue Law *— Income Tax — Deduction — Interest payable on replacement/refinancing loan — Whether deductible — Whether interest is connected with production of income — Income Tax Act 1967 s 33(1)(a)(i)*

The appellants were involved in the business of extraction and sale of timber logs. They were required to pay royalty on all the logs sold to the Forest Department. The appellants applied for a loan ('the first loan') for the purpose of payment of royalty. The appellants then obtained another loan ('the second loan') and with the approval of the bank, the second loan was utilized to settle the first loan. The respondent disallowed claims for deductions by the appellants in respect of certain amounts of money paid to the bank as interest under the two loan agreements. The Special Commissioners held that s 33(1)(a)(i) of the Income Tax Act 1967 ('the Act') has no application to cases where interest is paid on money borrowed to settle a debt as it does not amount to it being employed in the production of income. It was argued that the second loan could not be said to be employed in the production of income because it was not towards payment of royalties but to settle a debt already owing. It was also argued that the two loans were different in nature because the recipients of the money under the two loans were different. The appellant appealed.

Held, allowing the appeal:

For interest on money borrowed to pay essential business debts to be deductible, the debt in question must be connected with the production of income. The court disagreed with the argument that the two loans were different because the recipients of the money under the two loans were different. The fact that the Revenue was not informed of the purpose of the second loan and that the letter from the bank did not specifically state that the approval of the second loan was for payment of royalties were not significant consideration. What was of real importance was that the second loan was fully used to pay off the first loan. In the circumstances and the undisputed facts in this case, the court agreed that the second loan should be considered as a replacement loan or refinancing. It followed that since interest payments on the first loan were deductible — as conceded by the Revenue — because they fell within the provisions of s 33(1)(a) of the Act, interest payments on the second loan would also be deductible for income tax purposes (see pp 672F–I and 673A–B).

A [**Bahasa Malaysia summary**

Perayu-perayu terlibat dalam perniagaan pengeluaran dan penjualan kayu balak. Mereka dikehendaki membayar royalti ke atas kesemua kayu balak yang dijual kepada Jabatan Perhutanan. Perayu-perayu telah memohon untuk mendapatkan satu pinjaman ('pinjaman B pertama tersebut') bagi tujuan pembayaran royalti. Perayu-perayu kemudiannya telah memperolehi satu pinjaman yang lain ('pinjaman kedua') dan dengan kelulusan bank, pinjaman kedua telah digunakan untuk menjelaskan pinjaman pertama. Penentang telah tidak membenarkan tuntutan untuk potongan oleh perayu-perayu berhubung dengan jumlah wang tertentu yang dibayar kepada bank C sebagai faedah di bawah kedua-dua perjanjian pinjaman tersebut. Pesuruhjaya Khas telah memutuskan bahawa s 33(1)(a)(i) Akta Cukai Pendapatan 1967 ('Akta tersebut') tidak terpakai kepada kes-kes di mana faedah dibayar ke atas wang yang dipinjam untuk menjelaskan sesuatu hutang kerana ia tidak membawa kepada ianya digunakan D dalam penghasilan pendapatan. Adalah dihujahkan bahawa pinjaman kedua tidak boleh diperkatakan sebagai telah digunakan dalam penghasilan pendapatan kerana ia tidak digunakan terhadap pembayaran royalti-royalti tetapi untuk menjelaskan hutang yang telah pun terhutang. Adalah juga dihujahkan bahawa kedua-dua pinjaman tersebut mempunyai sifat yang berlainan kerana penerima E wang di bawah kedua-dua pinjaman tersebut adalah berlainan. Perayu telah merayu.

Diputuskan, membenarkan rayuan:

Untuk faedah ke atas wang yang dipinjamkan bagi membayar hutang F perniagaan yang penting menjadi boleh dipotong, hutang yang dipersoalkan itu semestinya dikaitkan dengan penghasilan pendapatan. Mahkamah tidak bersetuju dengan hujahan bahawa kedua-dua pinjaman tersebut berbeza kerana penerima wang tersebut di bawah kedua-dua pinjaman adalah berlainan. Hakikat bahawa Lembaga Hasil telah tidak dimaklumkan mengenai tujuan pinjaman kedua dan G bahawa surat daripada bank tersebut tidak secara khususnya menyatakan bahawa kelulusan pinjaman kedua adalah untuk pembayaran royalti-royalti bukannya merupakan pertimbangan yang ketara. Apa yang sesungguhnya penting adalah bahawa pinjaman kedua telah digunakan sepenuhnya untuk melunaskan pinjaman H pertama. Dalam keadaan tersebut dan fakta-fakta kes ini yang tidak dipertikaikan, mahkamah bersetuju bahawa pinjaman kedua seharusnya dianggap sebagai satu pinjaman penggantian atau pembiayaan semula. Ini bermakna bahawa oleh kerana pembayaran-pembayaran faedah ke atas pinjaman pertama boleh dipotong — sepertimana yang diakui oleh Lembaga Hasil — kerana ia terlingkung I dalam peruntukan-peruntukan s 33(1)(a) Akta tersebut, pembayaran-pembayaran faedah ke atas pinjaman kedua adalah juga boleh dipotong bagi tujuan cukai pendapatan (lihat ms 672F–I dan 673A–B).]

Notes

For cases on deduction for income tax, see 10 *Mallal's Digest* (4th Ed, 1996 Reissue) paras 1796–1822.

Cases referred to

British Insulated & Helsby Cables Ltd v Antherton [1926] AC 205 (refd)
DGIR v Kulim Rubber Plantations Ltd [1981] 1 MLJ 214 (refd)
DGIR v Rakyat Berjaya Sdn Bhd [1984] 1 MLJ 248 (refd)
FC of T v JD Roberts 92 ATC 4380 (refd)
Hoe Cheong Products Co Ltd v Cargill Hongkong Ltd [1995] 1 WLR 404 (refd)
Kidston Goldmines Ltd v FC of T 91 ATC 4538 (refd)
Port Elizabeth Electric Tramway Co Ltd v CIR 8 SATC 13 (refd)
W Nevill & Co Ltd v FC of T [1937] ALR 210 (refd)

Legislation referred to

Income Tax Act 1967 s 33(1)(a), (2)

Davidson (*Shelley Yap Leong Tseu Chong Chia & Co*) for the appellants.
Kok Keng Fai (Legal Officer) for the respondent.

Cur Adv Vult

Charles Ho J: This is an appeal from the decision of the Special Commissioners of Income Tax upon a case stated under paras 34 and 35 of Sch 5 to the Income Tax Act 1967. By notices of additional assessments for the years of assessment 1983 to 1986 the respondent, relying on s 33(2) of the Act disallowed claims for deductions by the appellants in respect of certain amounts of money paid to the bank as interest under two loan agreements. Such claims for deduction were also disallowed by the respondent for the year of assessment 1987. In the deciding order dated 4 October 1994, the Special Commissioners decided that the interest payments on the loans in question did not fulfill the conditions of s 33(1)(a) of the Income Tax Act 1967, and could not qualify as deductions under the said section.

The facts are straightforward and not in dispute. The facts found by the Special Commissioners are set out in para 6 (pp 4–7) of the case stated. The facts which are relevant to the present appeal are briefly these: The appellants were wholly owned by Sabah Foundation. The appellants' sole business operation was extraction and sale of timber logs for which they must have a timber licence from the Forest Department, Sabah. The appellants were required to pay royalty on all the logs sold to the Forest Department. Royalty payments made up to 35% to 40% of the appellants' total expenditure. Logs were sold locally and overseas. In respect of export sales, the transaction was done in US dollars. In 1981, the appellants applied for a loan from Sabah Development Bank Bhd ('the first loan').

The bank approved a loan of RM70m on 21 December 1981 with the conditions, inter alia, that the loan was to be used strictly for the payment of royalty. At that time, royalty payments remained outstanding as the appellants faced cash flow problems arising from donations made to Yayasan Sabah and payments made to other bodies. The first loan was in fact utilized to pay royalty and as at 31 December 1981 an amount of RM64,013,227.50 was paid over to the Forest Department as payment of timber royalties.

On 7 May 1982, the appellants obtained another loan from the same bank for US$30m ('the second loan') 'to finance working capital requirements and investments in project'. The reason for the loan to be made in US dollars was because the timber logs were traded mainly in US dollars and the appellants wanted to take advantage of foreign exchange benefits and it also acts as a hedge against currency rate fluctuations. On 12 May 1982, the appellants informed the bank their intention to repay the first loan and with the approval of the bank the second loan was utilized to settle the first loan to the extent of RM63,750,400 by direct debiting. At that time, appellants had already started paying interest on the first loan and after the repayment appellants paid interest to the bank on the second loan.

The issue relevant to the present appeal determined by the Special Commissioners was:

> Whether certain amount of interest paid by the appellants in respect of two loans taken from a bank for the payment of royalty are allowable as deductions in the computation of taxable income of the appellants pursuant to s 33(1)(a) of the Income Tax Act 1967 for the years of assessment 1983, 1984, 1985, 1986 and 1987.

At the outset of the hearing of this appeal, Mr Davidson, counsel for the appellants said that the appellants' case comes under the specific provisions of s 33(1)(a) of the Act and they do not have to rely on the general provisions of s 33(1) and the decision in *DGIR v Rakyat Berjaya Sdn Bhd* [1984] 1 MLJ 248. Mr Davidson also told the court that he has no quarrel with the conclusion reached by the Special Commissioners regarding the meaning to be given to the words 'outgoing and expenses wholly and exclusively incurred during the period by that person in the production of gross income from that source'. It can be seen from pp 9–14 of the case stated that the Special Commissioners discussed the matter at considerable length and referred to a number of authorities before coming to the conclusion as they did. Mr Davidson then concentrated his arguments based on the provisions of s 33(1)(a). This has narrowed down the arguments before the court a lot. When Mr Kok, counsel for the respondent, in the course of his submission, conceded that if the appellants had continued with the first loan the interest paid in respect of the said loan would qualify for deduction under s 33(1)(a), the issue before this court was further narrowed down.

The reasons given by the Special Commissioners for their decision that the appellants were not entitled to claim deductions under s 33(1)(a) are to be found at pp 15–18 of the case stated. In coming to the conclusion

that the appellants' case did not come under s 33(1)(a), the Special Commissioners said:

> In the appeal before us, the money borrowed was used for the purpose of settling debts which were allegedly incurred in the production of income. The payment of the debts does not relate to production of income as the income would have already been produced when the debt was incurred. The subsequent settlement of the debt has nothing to do with the income which had been produced earlier. It only plays an indirect part in the production of income. We therefore held that s 33(1)(a)(i) has no application to cases where interest is paid on money borrowed to settle a debt as it does not amount to it being employed in the production of income. On this ground alone, the appeal ought to be dismissed.

Before coming to the above conclusion, the Special Commissioners considered two authorities, viz *Port Elizabeth Electric Tramway Co Ltd v CIR* 8 SATC 13 and the New Zealand case of *Ward & Co Ltd v Taxes Commissioner* [1923] AC 145.

Counsel for the appellants says that he has no quarrel with *Port Elizabeth*'s case as he himself, would be relying on it as well. As regards *Ward*'s case, which held that the expenditure must have been incurred for the direct purpose of producing profits, Mr Davidson says that such a test, which by implication excludes expenditure indirectly incurred for the purpose of producing profits, is too narrow a test. He pointed out that the test applied in *Ward*'s case had not been followed by the House of Lords, the Australian High Court and our Federal Court. It is much narrower than the test in *Port Elizabeth*'s case and contrary to modern practice. Clearly our Federal Court in *DGIR v Kulim Rubber Plantations Ltd* [1981] 1 MLJ 214 adopted the wider test in *British Insulated & Helsby Cables Ltd v Atherton* [1926] AC 205. The relevant passage of the judgment of the House of Lords which laid down the *Atherton*'s test reads (at p 212):

> ... a sum of money expended, not of necessity and with a view to a direct and immediate benefit to the trade, but voluntarily and on the grounds of commercial expediency, and in order indirectly to facilitate the carrying on of the business, may yet be expended wholly and exclusively for the purposes of the trade.

The High Court of Australia in *W Nevill & Co Ltd v FC of T* [1937] ALR 210 followed the *Atherton* test. These cases have not been cited before the Special Commissioners and it would appear that they have applied the *Ward*'s test in the present case when they said that the second loan 'only plays an indirect part in the production of income'.

It is submitted by counsel for the appellants that the Special Commissioners' view that borrowed money must be the cause of the income and that the borrowing must come first was a sweeping and generalised statement of the law unsupported by authorities. Counsel referred the court to *FC of T v JD Roberts* 92 ATC 4380 at p 4387 where Hill J in delivering the judgment of the Full Federal Court said:

> The mere act of borrowing money, burdened with the obligation to pay interest, does not of itself gain or produce assessable income. The amount

borrowed is not assessable income. What operates to gain or produce assessable income is the manner in which those moneys are used, so that the necessary connection between the outgoing for interest and the activities which more directly gain or produce assessable income will be found, in the ordinary case, in the use to which the borrowed funds are put.

Counsel also cited another passage from the judgment of Hill J in *Kidston Goldmines Ltd v FC of T* 91 ATC 4538 at p 4545 where his Lordship said:

> This is not to say that tests such as the purpose of the borrowing or the use and application of the borrowed funds are irrelevant. Rather, they are tools to assist in the resolution of what is essentially a question of fact. To be deductible the outgoing, or in a case of apportionment a part of an indivisible outgoing, must be seen to be incidental and relevant to the activity and can still, in the year of income in which the deduction is claimed, be seen as having that purpose, will lead readily to the conclusion that the interest will be incidental and relevant to the income producing activity. Again, in the usual case the application of funds to an income producing purpose will demonstrate the relevant connection between the outgoing and the income producing activity. Indeed there is much to be said for the view that the tests of purpose and application of funds are but two sides of the one matter.

Counsel for the appellants then submitted that money borrowed and interest on money borrowed to pay essential business debt is an allowable deduction whether or not the income had been produced at the time of settlement of the debt. Payment for debts is an essential part of the business. The first loan was raised to pay royalties which is essential business expense. The second loan, which counsel says was a replacement loan, was taken so that the liability would be in US dollars and not in ringgit and the refinancing did not change the character of the loan (see *Roberts'* case).

The Special Commissioners also considered the appellants' claim for deduction on the assumption that s 33(1)(a) applied to such claim. For reasons given at pp 16–18 of the case stated, they were of the opinion that the appellants would still not be entitled to claim for deduction in respect of interest paid on the second loan. Those reasons, as far as I can understand them, may be summarised as follows:

(a) if the appellants had used the gross profits they received in 1980, 1981, and 1982 to pay royalties, and if the appellants had not in 1979 made huge donations (RM80m) to Yayasan Sabah, the appellants would not have to borrow from the bank to pay for the royalties which were allowed to remain as a debt. There was therefore improper use of income and the debt arising out of that cannot be described as a debt that arose in the course of production of income;

(b) the appellants had failed to inform the respondent that the loans were utilised as claimed by the appellants; and

(c) the letter of approval from the Sabah Development Bank Bhd says that the second loan was taken to finance working capital requirements and investments in projects.

Counsel for the appellants says that he objects to the Special Commissioners relying on ground (a) above as it was not argued before them (see *Hoe Cheong Products Co Ltd v Cargill Hongkong Ltd* [1995] 1 WLR 404). After pointing out that the donations in question were made in 1979, two years before the first loan was obtained, counsel argued that the Special Commissioners have no right to enquire into the question of reasonableness and to say that the appellants could have avoided borrowing by not making donations. As regards paras (b) and (c) above, I am of the view that since the Special Commissioners have found that second loan was used to settle the first loan, they are no longer relevant.

The contention of Mr Kok, counsel for the respondent, as I understand it, is to the effect that the second loan cannot be said to be employed in the production of incomes because it was not towards payment of royalties but to settle a debt already owing. The royalties had already been paid. Mr Kok further says that before the Special Commissioners it was not argued that the second loan was to replace the first loan and that the two loans were different in nature in respect of the payment; the recipient of the money borrowed under the first loan was the Forest Department, the recipient of the money under the second loan was the bank. It is submitted by Mr Kok that even if *Atherton*'s test is applied, the interest arising from the second loan would still fail to qualify for deduction. He says that he cannot agree that interest on money borrowed to pay essential business debt is allowable deduction whether or no income was produced. As regards *Roberts*' case he says that we must be careful when we refer to authorities of other jurisdiction. We must give due considerations to the differences in the wordings between the provisions. I do not think there is any doubt that, for interest on money borrowed to pay essential business debt to be deductible, the debt in question must be connected with the production of income.

During his submission, counsel for the respondent was asked by the court this question. If the first loan had in fact been used for payment of royalties, would the interest payment on the loan be deductible for income tax purposes? Counsel's answer is in the affirmative. In the light of the answer and the submission of counsel on both sides, we seem to have narrowed the whole case down to the purpose of the second loan. Was it a totally separate loan not connected directly or indirectly with the production of income? Or was it a replacement loan?

There is no dispute that the second loan was utilized to pay off the first loan, so instead of paying interest on the first loan, the appellants paid interest on the second loan. The Sabah Development Bank allowed the second loan to be used to settle the first loan. According to counsel for the appellants, the second loan was in fact a replacement loan, the same as refinancing. Counsel says that the replacement loan was taken so that the liability could be in US dollars and not in ringgit but this did not change the character of the loan. I must confess I cannot quite follow the argument by counsel for the respondent that the two loans were different because the recipients of the money under the two loans were different. I do not think that the fact that Revenue was not informed of the purpose of the second

A loan and that the letter from the Bank did not specifically state that the approval of the second loan was for payment of royalties are significant considerations. To my mind what is of real importance is that the second loan was fully used to pay off the first loan. In the circumstances and the undisputed facts in this case, I agree with counsel for the appellants that the second loan should be considered as a replacement loan or refinancing. It follows, as a matter of logic and common sense that since interest payments on the first loan were deductible (conceded by Revenue) because they fall within the provisions of s 33(1)(a) of the Act, interest payments on the second loan would also be deductible for income tax purposes.

For reasons given above, I am of the view that the appeal should be allowed.

Appeal allowed.

Reported by Jafisah Jaafar